UIL 511.00-00

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200108051

Date: NOV 30 2000

Contact Person:

ID Number:
T:EO:1
Telephone Number:

Employer Identification Number:
Area Office:

Legend:

A =
B =
C =
D =
E =
F =
G =
H =
I =
J =
K =
L =
M =
N =

Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the transactions described below.

A is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is a nonprivate foundation under section 509(a)(3). A was organized to promote health by acting as the parent of a nonprofit healthcare system and by raising funds and otherwise supporting the system. A is controlled by a community-based Board of Directors and is the sole member of various section 501(c)(3) health care corporations, including several acute care hospitals, several skilled nursing facilities, a home health organization, a hospice, a school of nursing and a medical research foundation. A is also a shareholder in various active and inactive taxable corporations.

B, C and D are exempt from federal income tax under section 501(c)(3) of the Code and are classified as nonprivate foundations under sections 509(a)(1) and 170(b)(1)(A)(iii). They are acute care hospitals which comply with Revenue Ruling 69-545, 1969-1 C.B. 117.

E, F, G and H are exempt from federal income tax under section 501(c)(3) of the Code and are classified as nonprivate foundations under section 509(a). They operate residential care facilities.

304

A is the sole member of I and J. I provides home health services and is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(2). I also provides hospice services which were previously conducted by J, a section 501(c)(3) organization which was merged into I.

A is the sole member of K, which operates a school of nursing and is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(ii).

A is the sole member of L, a research foundation which is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(ii).

M is a professional corporation providing health care services which is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii).

You have stated that A and M are not presently affiliated but are related through their shared mission of providing services to the general public. M's main facility is shared with A and B and A and M serve a substantially identical service area. In addition, A is the sole member of B, the hospital that serves as the teaching hospital for M's physicians and the substantial majority of physicians that practice, teach and conduct research at B are employed by M. These physicians also practice and teach clinical services at other community health centers operated by A.

You have stated that it has become clear to A and M that developing a new corporate structure which would integrate their assets and management would allow them to better fulfill their missions and provide flexibility for the parties. Toward this end, A and M propose to enter into an affiliation agreement to delegate significant authority to a newly created entity, N. The affairs of N will be governed by a board selected by A and M.

Pursuant to the agreement, N will be empowered to: (a) develop, approve and oversee a system-wide operating and capital budget and approve the operating and capital budgets of each of the system members; (b) develop, adopt, modify, supplement and execute a system-wide strategic plan, which must be followed by each system member; (c) establish the system's mission, vision and values which shall be consistent with the goals and objectives of N outlined in the agreement; (d) allocate cash flow from operations and all realized income and gains from investment portfolios of all system members in a manner necessary or desirable to implement the system-wide budget or strategic plan or to otherwise accomplish the goals and objectives of the system and direct the transfer of property from one system member to another for any of these purposes; (e) incur debt on behalf of the system or on behalf of any one or more system members and require contributions in cash or cash equivalents from system members in an aggregate amount up to $40 million in any one year to support working capital needs or capital projects in furtherance of the goals and objectives of the system (both the boards of A and M would be required to approve incurrence of debt or use of cash in excess of $40 million in any one year); (f) approve the incurrence of material debt and the disposition of any property or cash by a system member to a non-member; (g) develop new strategic relationships on behalf of the system or system members and require participation by system members in such relationships and approve participation by system members in key strategic relationships outside the group; (h) require a system member to add, delete, modify or relocate services that would, in the judgement of N, have system-wide implications and approve the

addition, deletion, or modification of services by a system member; (i) establish rates for the entire system, approve payor and other health care services contracts for the system and require participation by system members in such contracts; (j) approve fundamental transactions, including amendments to articles of incorporation, bylaws, mergers, consolidations, dissolutions, liquidations, divisions and dispositions of substantially all the assets involving system members and the creation or acquisition of any new affiliate by a member; (k) monitor and enforce compliance by system members relative to the policies and directives of N; (l) conduct a comprehensive annual assessment of the executives of the system and, under certain circumstances, remove such individuals from their offices and require the boards of A and M to remove and replace their chief executives after a cure period; (m) determine the aggregate amount of compensation and income distribution plan to be paid to physicians employed by the system; (n) determine the number and type of physicians required to implement the system-wide strategic plan and to otherwise accomplish the goals and objectives of the system and (o) to approve the addition of new system members and request the withdrawal of any system member except A and M.

In carrying out these responsibilities, you have stated that N will be empowered to reallocate assets among system members without requiring a loan or a loan structure.

You have stated that generally 10 members of N's board will constitute a quorum for purposes of conducting business and the affirmative vote of 51% of the members of the board present at a meeting at which a quorum is present will be the act of the board. However, an affirmative vote of 10 of the 14 members of N's board will be required for the following actions to be taken: (a) approval of the annual operating and capital budgets; (b) approval of the system-wide strategic plan; (c) approval of the enterprise mission statement; (d) approval of the aggregate amount of physician compensation; (e) approval of the number and type of physicians required to implement the system-wide strategic plan; (f) approval of any proposed variance from established restrictive covenant policies included in physician employment agreements that have system-wide implications; (g) incurrence of debt and disposal of assets; (h) removal of the chief executives of A and M; (i) capital expenditures of more than $1 million not included in a previously approved budget; (j) admission of any new system members; (k) approval of key strategic relationships outside the group and (l) approval of the addition, modification or discontinuance of certain member programs and services.

You have stated that it is expected that the board and committees of N will meet regularly to exercise the powers granted to N. Any dispute, controversy or claim between the parties as to matters arising out of or relating to the agreement will be resolved in accordance with specified procedures involving mediation and/or binding arbitration.

You have stated that the affiliation cannot be terminated after closing except for either: (a) the occurrence of a specific "for cause" event defined to include (i) threatened revocation of the tax-exempt or public charity status of a section 501(c)(3) system member or (ii) change of law or interpretation of law which, absent a termination, would result in material adverse consequences to A or M and its affiliates taken as a whole; (b) a material breach of the agreement by a party which breach causes material adverse consequences to the other party; (c) refusal by a substantial portion of the representatives of A or M to attend and actively participate in three consecutive meetings of the board of N and (d) obstructive conduct by a board member which materially interferes with the ability of the system to function and is not corrected during a defined time period. In the case of a material breach, the non-breaching party can first require the breaching party to cure the breach prior to terminating the affiliation. In the case of termination caused by a material breach, the breaching party will be required to pay a substantial monetary penalty. In the event of a dispute as

to whether a material breach or "for cause" event has occurred, the dispute will be submitted to binding arbitration.

You have stated that following the third anniversary of the closing date of the affiliation, the affiliation may be terminated by the mutual consent of both parties. This requires that: (a) 75% of the members of the board of A and M vote to terminate the affiliation on two occasions; (b) prior to termination the parties first seek the advice of an independent expert concerning the consequences of termination and (c) following the second termination meeting by the boards of A and M, at least 51% of M's shareholders and 51% of A's trustees, in separate meetings of such bodies, also vote to terminate the affiliation.

You have requested the following rulings in connection with the affiliations and reorganization described above:

1. The proposed transactions will not adversely affect the tax-exempt status under section 501(c)(3) of A or M and their section 501(c)(3) affiliates.

2. A, M and their section 501(c)(3) affiliates will continue to qualify as other than private foundations under section 509(a) of the Code.

3. The transfer of resources and sharing of goods, facilities and service among A, M and their section 501(c)(3) affiliates will not produce unrelated business income under sections 511 through 514 of the Code.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c)(3), including organizations that are organized and operated exclusively for charitable, educational or scientific purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Revenue Ruling 69-545, 1969-2 C.B. 117, acknowledges that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 78-41, 1978-1 C.B. 148, concludes that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for charitable purposes and is exempt under section 501(c)(3) of the Code.

Section 1.509(a)-4(f)(1) of the regulations provides that section 509(a)(3)(B) of the Code sets forth three different types of relationships, one of which must be met in order to meet the requirements of the subsection. One of those requirements is operated, supervised or controlled in connection with. Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are supervised or controlled in connection with one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors.

Section 511(a) of the Code imposes a tax on the unrelated business income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines unrelated business taxable income as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of the trade or business, with certain modifications.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

Section 1.513-1(d)(2) of the regulations provides, in part, that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related for purposes of section 513 of the Code only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes.

Providing management and consultants' services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See BSW Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

An organization providing laundry services on a centralized basis to exempt hospitals does not qualify for exemption under section 501(c)(3). See HCSC-Laundry v. United States, 450 U.S.1 (1981).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

Rev. Rul. 77-72, 1977-1 C.B. 157, provides that indebtedness owed to a labor union by its wholly owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of section 514 of the Code since the parent and subsidiary relationship shows the indebtedness to be merely a matter of accounting.

In Geisinger Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinger), the court recognized that an organization may qualify for exemption based on the integral part doctrine, which arises from an exception to the "feeder organization" rule set forth in section 1.502-1(b) of the regulations, which states that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with the parent organization. The court also noted that an entity seeking exemption as an integral part of another cannot primarily be engaged in activity which would generate more than insubstantial unrelated business income if

engaged in by the other entity. In this regard, the court followed the reasoning of section 1.502-1(b), which contains an example of a subsidiary organization that is not exempt from tax because it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. The example states that if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations) it is not exempt because such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Accordingly, the court in Geisinger determined that application of the integral part doctrine requires at a minimum that an organization be in a parent and subsidiary relationship and that it not be carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

An affiliation between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, the courts have been clear that exemption under section 501(c)(3) of the Code is not generally available where an organization is established to provide corporate services to unrelated exempt organizations, other than through the application of section 501(e) of the Code for cooperative hospital service organizations. See BSW Group, Inc., supra, and HCSC-Laundry, supra. Furthermore, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinger, supra, and Rev. Rul. 78-41, supra. With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in an affiliated system of organizations with common control, then corporate services provided between them necessary to their being able to accomplish their exempt purposes are treated as other than an unrelated trade or business and the financial arrangements between them are viewed as merely a matter of accounting. See Rev. Rul. 77-72, supra.

At issue, then, is whether the affiliation established an affiliated system with sufficient common control such that corporate services and payments provided between the participating affiliates will not be treated as unrelated trade or business income.

Based on all the facts and circumstances, we conclude that the affiliation effectively binds the participating affiliates under the common control of N so that the participating entities are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of N's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating affiliates have ceded authority to N's governing body to develop annual operating and capital budgets for the system and to approve the annual operating and capital budgets of each former system, design and implement strategic plans for the system and approve the strategic plans of each of the former systems, approve the incurrence of debt by any former system affiliate and require participation by the former systems and their affiliates in system-wide debt, require the affiliates to make capital contributions to N and approve the proposed sale or transfer of assets. In addition, N's board of trustees meets regularly to exercise overall responsibility for operational

decisions and to monitor the affiliates compliance with N's decisions. Therefore, the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system are treated as other than an unrelated trade or business.

Contributions to organizations exempt from federal income tax under section 501(c)(3) of the Code do not fall within the definition of unrelated business income under section 512, nor create taxable gain or loss to the transferor or transferee.

The participating affiliates will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. The participating entities will continue to qualify as nonprivate foundations under section 509(a) of the Code because they will continue to maintain the relationships and/or activities serving as the basis for their nonprivate foundation status.

Accordingly, based on all the facts and circumstances described above, we rule:

1. The proposed transactions will not adversely affect the tax-exempt status under section 501(c)(3) of A or M and their section 501(c)(3) affiliates.

2. A, M and their section 501(c)(3) affiliates will continue to qualify as other than private foundations under section 509(a) of the Code.

3. The transfer of resources and sharing of goods, facilities and service among A, M and their section 501(c)(3) affiliates will not produce unrelated business income under sections 511 through 514 of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings are directed only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

These rulings do not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

We are informing your Area Office of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

310